4. Simplification of excise tax imposed on bows and arrows (sec. 404 of the Senate amendment and sec. 4161 of the Code)

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw rate of 10 pounds or more (sec. 4161(b)(1)(A)). An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches) (sec. 4161(b)(2)). No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches) (sec. 4161(b)(1)(B)).

House Bill

No provision.

Senate Amendment

The Senate amendment increases the minimum draw weight for a taxable bow from 10 pounds to 30 pounds. The Senate amendment also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as an arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the provision. The Senate amendment provides that the 12-percent excise tax on arrows does not apply if the arrow contains an arrow shaft that was subject to the tax on arrow components. Finally, the Senate amendment subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective date.–The Senate amendment provision is effective on the date of enactment for articles sold by the manufacturer, producer, or importer.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Agricultural Provisions

1. Capital gains treatment to apply to outright sales of timber by landowner (sec. 411 of the Senate Amendment and sec. 631 of the Code)

Present Law

Under present law, a taxpayer disposing of timber held for more than one year is eligible for capital gains treatment in three situations. First, if the taxpayer sells or exchanges timber that is a capital asset (sec. 1221) or property used in the trade or business (sec. 1231), the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer's business, the gain will be ordinary income. Second, if the taxpayer disposes of the timber with a retained economic interest, the gain is eligible for capital gain treatment (sec. 631(b)). Third, if the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)).

House Bill

No provision.

Senate Amendment

Under the Senate amendment, in the case of a sale of timber by the owner of the land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gain under section 631(b) does not apply. Outright sales of timber by the landowner will qualify for capital gains treatment in the same manner as sales with a retained economic interest qualify under present law, except that the usual tax rules relating to the timing of the income from the sale of the timber will apply (rather than the special rule of section 631(b) treating the disposal as occurring on the date the timber is cut).

Effective date.–The Senate amendment provision is effective for sales of timber after the date of enactment.

Conference Agreement

The conference agreement does not contain the provision in the Senate amendment.

2. Special rules for livestock sold on account of weather-related conditions (sec. 412 of the Senate amendment and secs. 1033 and 451 of the Code)

Present Law

A taxpayer generally recognizes gain on the sale of property to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period"). Special rules extend the replacement period for certain real property and principal residences damaged by a Presidentially declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized.

Section 1033(e) provides that the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought, flood, or other weather-related conditions is treated as an involuntary conversion. Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought, flood, or other weather-related conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the weather-related condition.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized. The extension is only available if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis should the weather-related conditions continue longer than three years. For property eligible for the provision's extended replacement period, the provision provides that the taxpayer can make an election under section 451(e) until the period for reinvestment of such property under section 1033 expires.

Effective date.–The Senate amendment provision is effective for any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Exclusion from gross income for amounts paid under National Health Service Corps loan repayment program (sec. 413 of the of the Senate amendment and sec. 108 of the Code)

Present Law

The National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") provides loan repayments to participants on condition that the participants provide certain services. In the case of the NHSC Loan Repayment Program, the recipient of the loan repayment is obligated to provide medical services in a geographic area identified by the Public Health Service as having a shortage of health-care professionals. Loan repayments may be as much as $35,000 per year of service plus a tax assistance payment of 39 percent of the repayment amount.

Generally, gross income means all income from whatever source derived including income for the discharge of indebtedness. However, gross income does not include discharge of indebtedness income if: (1) the discharge occurs in a Title 11 case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) except in the case of a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Because the loan repayments provided under the NHSC Loan Repayment Program are not specifically excluded from gross income, they are gross income to the recipient.

House Bill

No provision.

Senate Amendment

The Senate amendment provision excludes from gross income loan repayments provided under the NHSC Loan Repayment Program.

Effective date.–The Senate amendment provision is effective with respect to amounts received by an individual in taxable years beginning after December 31, 2002.

Conference Agreement

The Conference agreement does not include the Senate amendment provision.

4. Payment of dividends on stock of cooperatives without reducing patronage dividends (sec. 414 of the Senate amendment and sec. 1388 of the Code)

Present Law

Under present law, cooperatives generally are entitled to deduct or exclude amounts distributed as patronage dividends in accordance with Subchapter T of the Code. In general, patronage dividends are comprised of amounts that are paid to patrons (1) on the basis of the quantity or value of business done with or for patrons, (2) under a valid and enforceable obligation to pay such amounts that was in existence before the cooperative received the amounts paid, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[319] The dividend allocation rule has been interpreted to require that such dividends be allocated between a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

House Bill

No provision.

Senate Amendment

The Senate amendment provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income and do not prevent the cooperative from being treated as operating on a cooperative basis.

Effective date.–The Senate amendment provision is effective for distributions made in taxable years ending after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[319] Treas. Reg. sec. 1.1388-1(a)(1).

VII. SIMPLIFICATION AND OTHER PROVISIONS

A. Establish Uniform Definition of a Qualifying Child (secs. 501 through 508 of the Senate amendment and secs. 2, 21, 24, 32, 151, and 152 of the Code)

Present Law

In general

Present law contains five commonly used provisions that provide benefits to taxpayers with children: (1) the dependency exemption; (2) the child credit; (3) the earned income credit; (4) the dependent care credit; and (5) head of household filing status. Each provision has separate criteria for determining whether the taxpayer qualifies for the applicable tax benefit with respect to a particular child. The separate criteria include factors such as the relationship (if any) the child must bear to the taxpayer, the age of the child, and whether the child must live with the taxpayer. Thus, a taxpayer is required to apply different definitions to the same individual when determining eligibility for these provisions, and an individual who qualifies a taxpayer for one provision does not automatically qualify the taxpayer for another provision.

Dependency exemption[320]

In general

Taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. For 2003, the amount deductible for each personal exemption is $3,050. The deduction for personal exemptions is phased out for taxpayers with incomes above certain thresholds.[321]

In general, a taxpayer is entitled to a dependency exemption for an individual if the individual: (1) satisfies a relationship test or is a member of the taxpayer's household for the entire taxable year; (2) satisfies a support test; (3) satisfies a gross income test or is a child of the taxpayer under a certain age; (4) is a citizen or resident of the U.S. or resident of Canada or

[320] Secs. 151 and 152. Under the statutory structure, section 151 provides for the deduction for personal exemptions with respect to "dependents." The term "dependent" is defined in section 152. Most of the requirements regarding dependents are contained in section 152; section 151 contains additional requirements that must be satisfied in order to obtain a dependency exemption with respect to a dependent (as so defined). In particular, section 151 contains the gross income test, the rules relating to married dependents filing a joint return, and the requirement for a taxpayer identification number. The other rules discussed here are contained in section 151.

[321] Sec. 151(d)(3).

Mexico;[322] and (5) did not file a joint return with his or her spouse for the year.[323] In addition, the taxpayer identification number of the individual must be included on the taxpayer's return.

Relationship or member of household test

Relationship test.–The relationship test is satisfied if an individual is the taxpayer's (1) son or daughter or a descendant of either (e.g., grandchild or great-grandchild); (2) stepson or stepdaughter; (3) brother or sister (including half brother, half sister, stepbrother, or stepsister); (4) parent, grandparent, or other direct ancestor (but not foster parent); (5) stepfather or stepmother; (6) brother or sister of the taxpayer's father or mother; (7) son or daughter of the taxpayer's brother or sister; or (8) the taxpayer's father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law.

An adopted child (or a child who is a member of the taxpayer's household and who has been placed with the taxpayer for adoption) is treated as a child of the taxpayer. A foster child is treated as a child of the taxpayer if the foster child is a member of the taxpayer's household for the entire taxable year.

Member of household test.–If the relationship test is not satisfied, then the individual may be considered the dependent of the taxpayer if the individual is a member of the taxpayer's household for the entire year. Thus, a taxpayer may be eligible to claim a dependency exemption with respect to an unrelated child who lives with the taxpayer for the entire year.

For the member of household test to be satisfied, the taxpayer must both maintain the household and occupy the household with the individual.[324] A taxpayer or other individual does not fail to be considered a member of a household because of "temporary" absences due to special circumstances, including absences due to illness, education, business, vacation, and military service.[325] Similarly, an individual does not fail to be considered a member of the taxpayer's household due to a custody agreement under which the individual is absent for less than six months.[326] Indefinite absences that last for more than the taxable year may be considered "temporary." For example, the IRS has ruled that an elderly woman who was indefinitely confined to a nursing home was temporarily absent from a taxpayer's household.

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[322] A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a dependent (provided other applicable requirements are met) if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States. Sec. 152(b)(3).

[323] This restriction does not apply if the return was filed solely to obtain a refund and no tax liability would exist for either spouse if they filed separate returns. Rev. Rul. 54-567, 1954-2 C.B. 108.

[324] Treas. Reg. sec. 1.152-1(b).

[325] *Id.*

[326] *Id.*

Under the facts of the ruling, the woman had been an occupant of the household before being confined to a nursing home, the confinement had extended for several years, and it was possible that the woman would die before becoming well enough to return to the taxpayer's household. There was no intent on the part of the taxpayer or the woman to change her principal place of abode.[327]

Support test

In general.–The support test is satisfied if the taxpayer provides over one half of the support of the individual for the taxable year. To determine whether a taxpayer has provided more than one half of an individual's support, the amount the taxpayer contributed to the individual's support is compared with the entire amount of support the individual received from all sources, including the individual's own funds.[328] Governmental payments and subsidies (e.g., Temporary Assistance to Needy Families, food stamps, and housing) generally are treated as support provided by a third party. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. If any person furnishes support in kind (e.g., in the form of housing), then the fair market value of that support must be determined.

Multiple support agreements.–In some cases, no one taxpayer provides more than one half of the support of a individual. Instead, two or more taxpayers, each of whom would be able to claim a dependency exemption but for the support test, together provide more than one half of the individual's support. If this occurs, the taxpayers may agree to designate that one of the taxpayers who individually provides more than 10 percent of the individual's support can claim a dependency exemption for the child. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the taxpayer who claims the exemption.

Special rules for divorced or legally separated parents.–Special rules apply in the case of a child of divorced or legally separated parents (or parents who live apart at all times during the last six months of the year) who provide over one half the child's support during the calendar year.[329] If such a child is in the custody of one or both of the parents for more than one half of the year, then the parent having custody for the greater portion of the year is deemed to satisfy the support test; however, the custodial parent may release the dependency exemption to the noncustodial parent by filing a written declaration with the IRS.[330]

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[327] Rev. Rul. 66-28, 1966-1 C.B. 31.

[328] In the case of a son, daughter, stepson, or stepdaughter of the taxpayer who is a full-time student, scholarships are not taken into account for purpose of the support test. Sec. 152(d).

[329] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child or foster child, or child placed with the taxpayer for adoption). Sec. 152(e)(1)(A).

[330] Special support rules also apply in the case of certain pre-1985 agreements between divorced or legally separated parents. Sec. 152(e)(4).

Gross income test

In general, an individual may not be claimed as a dependent of a taxpayer if the individual has gross income that is at least equal to the personal exemption amount for the taxable year.[331] If the individual is the child of the taxpayer and under age 19 (or under age 24, if a full-time student), the gross income test does not apply.[332] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child of the taxpayer, a foster child who resides with the taxpayer for the entire year, or a child placed with the taxpayer for adoption by an authorized adoption agency).

Earned income credit[333]

In general

In general, the earned income credit is a refundable credit for low-income workers. The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no "qualifying children." In order to be a qualifying child for the earned income credit, an individual must satisfy a relationship test, a residency test, and an age test. In addition, the name, age, and taxpayer identification number of the qualifying child must be included on the return.

Relationship test

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son, daughter, stepson, or stepdaughter, or a descendant of any such individual;[334] (2) brother, sister, stepbrother, or stepsister, or a descendant of any such individual, who the taxpayer cares for as the taxpayer's own child; or (3) eligible foster child. An eligible foster child is an individual (1) who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent.[335]

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[331] Certain income from sheltered workshops is not taken into account in determining the gross income of permanently and totally disabled individuals. Sec. 151(c)(5).

[332] Sec. 151(c).

[333] Sec. 32.

[334] A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

[335] Sec. 32(c)(3)(B)(ii).

Residency test

The residency test is satisfied if the individual has the same principal place of abode as the taxpayer for more than one half of the taxable year. The residence must be in the United States.[336] As under the dependency exemption (and head of household filing status), temporary absences due to special circumstances, including absences due to illness, education, business, vacation, and military service are not treated as absences for purposes of determining whether the residency test is satisfied.[337] Under the earned income credit, there is no requirement that the taxpayer maintain the household in which the taxpayer and the qualifying individual reside.

Age test

In general, the age test is satisfied if the individual has not attained age 19 as of the close of the calendar year. In the case of a full-time student, the age test is satisfied if the individual has not attained age 24 as of the close of the calendar year. In the case of an individual who is permanently and totally disabled, no age limit applies.

Child credit[338]

Taxpayers with incomes below certain amounts are eligible for a child credit for each qualifying child of the taxpayer. The amount of the child credit is up to $600, in the case of taxable years beginning in 2003 or 2004. The child credit increases to $700 for taxable years beginning in 2005 through 2008, $800 for taxable years beginning in 2009, and $1,000 for taxable years beginning in 2010. The credit declines to $500 in taxable year 2011.[339] For purposes of this credit, a qualifying child is an individual: (1) with respect to whom the taxpayer is entitled to a dependency exemption for the year; (2) who satisfies the same relationship test applicable to the earned income credit; and (3) who has not attained age 17 as of the close of the calendar year. In addition, the child must be a citizen or resident of the United States.[340] A portion of the child credit is refundable under certain circumstances.[341]

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[336] The principal place of abode of a member of the Armed Services is treated as in the United States during any period during which the individual is stationed outside the United States on active duty. Sec. 32(c)(4).

[337] IRS Publication 596, *Earned Income Credit (EIC)*, at 13. H. Rep. 101-964 (October 27, 1990), at 1037.

[338] Sec. 24.

[339] Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. No. 107-16, sec. 901(a) (2001) (making, by way of the EGTRRA sunset provision, the increase in the child credit inapplicable to taxable years beginning after December 31, 2010).

[340] The child credit does not apply with respect to a child who is a resident of Canada or Mexico and is not a U.S. citizen, even if a dependency exemption is available with respect to the child. Sec. 24(c)(2). The child credit is, however, available with respect to a child dependent who is not a resident or citizen of the United States if: (1) the child has been legally adopted by

Dependent care credit[342]

The dependent care credit may be claimed by a taxpayer who maintains a household that includes one or more qualifying individuals and who has employment-related expenses. A qualifying individual means (1) a dependent of the taxpayer under age 13 for whom the taxpayer is entitled to a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself,[343] or (3) the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself. In addition, a taxpayer identification number for the qualifying individual must be included on the return.

A taxpayer is considered to maintain a household for a period if over one half the cost of maintaining the household for the period is furnished by the taxpayer (or, if married, the taxpayer and his or her spouse). Costs of maintaining the household include expenses such as rent, mortgage interest (but not principal), real estate taxes, insurance on the home, repairs (but not home improvements), utilities, and food eaten in the home.

A special rule applies in the case of a child who is under age 13 or is physically or mentally incapable of caring for himself or herself if the custodial parent has waived his or her dependency exemption to the noncustodial parent.[344] For the dependent care credit, the child is treated as a qualifying individual with respect to the custodial parent, not the parent entitled to claim the dependency exemption.

Head of household filing status[345]

A taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half of the year of (1) an unmarried son, daughter, stepson or stepdaughter of the taxpayer or an unmarried descendant of the taxpayer's son or daughter, (2) an individual described in (1) who is married, if the taxpayer may claim a dependency exemption with respect to the individual (or could claim the exemption

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the taxpayer; (2) the child's principal place of abode is the taxpayer's home; and (3) the taxpayer is a U.S. citizen or national. *See* sec. 24(c)(2) and sec. 152(b)(3).

[341] Sec. 24(d).

[342] Sec. 21.

[343] Although such an individual must be a dependent of the taxpayer as defined in section 152, it is not required that the taxpayer be entitled to a dependency exemption with respect to the individual under section 151. Thus, such an individual may be a qualifying individual for purposes of the dependent care credit, even though the taxpayer is not entitled to a dependency exemption because the individual does not meet the gross income test.

[344] Sec. 21(e)(5).

[345] Sec. 2(b).

if the taxpayer had not waived the exemption to the noncustodial parent), or (3) a relative with respect to whom the taxpayer may claim a dependency exemption.[346] If certain other requirements are satisfied, head of household filing status also may be claimed if the taxpayer is entitled to a dependency exemption with respect to one of the taxpayer's parents.

House Bill

No provision.

Senate Amendment

Description of provision

In general

The Senate amendment provision establishes a uniform definition of qualifying child for purposes of the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status. A taxpayer may claim an individual who does not meet the uniform definition of qualifying child (with respect to any taxpayer) as a dependent if the present-law dependency requirements are satisfied. The Senate amendment Senate amendment provision does not modify other parameters of each tax benefit (e.g., the earned income requirements of the earned income credit) or the rules for determining whether individuals other than children qualify for each tax benefit.

Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Under the Senate amendment provision, the present-law support and gross income tests for determining whether an individual is a dependent generally do not apply to a child who meets the requirements of the uniform definition of qualifying child.

Residency test

Under the uniform definition's residency test, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. It is intended that, as is the case under present law, temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, would not be treated as absences.

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[346] Sec. 2(b)(1)(A)(ii), as qualified by sec. 2(b)(3)(B). An individual for whom the taxpayer is entitled to claim a dependency exemption by reason of a multiple support agreement does not qualify the taxpayer for head of household filing status.

Relationship test

In order to be a qualifying child under the Senate amendment provision, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. A legally adopted individual of the taxpayer, or an individual who is placed with the taxpayer by an authorized placement agency for adoption by the taxpayer, is treated as a child of such taxpayer by blood. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.[347]

Age test

Under the Senate amendment provision, the age test varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child.[348] In general, no age limit applies with respect to individuals who are totally and permanently disabled within the meaning of section 22(e)(3) at any time during the calendar year. The Senate amendment provision retains the present-law requirements that a child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit, and under age 17 (whether or not disabled) for purposes of the child credit.

Children who support themselves

Under the Senate amendment provision, a child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. The Senate amendment provision retains the present-law rule, however, that a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income credit.

Tie-breaking rules

If a child would be a qualifying child with respect to more than one individual (e.g., a child lives with his or her mother and grandmother in the same residence) and more than one person claims a benefit with respect to that child, then the following "tie-breaking" rules apply. First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent. Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child first with respect to the parent with whom the child resides for the longest period of time, and second with respect to the parent with the highest adjusted gross income. Third, if the child's parents do not claim

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[347] The provision eliminates the present-law rule requiring that if a child is the taxpayer's sibling or stepsibling or a descendant of any such individual, the taxpayer must care for the child as if the child were his or her own child.

[348] The provision retains the present-law definition of full-time student set forth in section 151(c)(4).

the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

Interaction with present-law rules

Taxpayers may claim an individual who does not meet the uniform definition of qualifying child with respect to any taxpayer as a dependent if the present-law dependency requirements (including the gross income and support tests) are satisfied.[349] Thus, for example, a taxpayer may claim a parent as a dependent if the taxpayer provides more than one half of the support of the parent and the parent's gross income is less than the exemption amount.

Children who are U.S. citizens living abroad or non-U.S. citizens living in Canada or Mexico may qualify as a qualifying child, as is the case under the present-law dependency tests. A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a qualifying child (provided other applicable requirements are met) if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States.

Children of divorced or legally separated parents

The Senate amendment provision generally retains the present-law rule that allows a custodial parent to release the claim to a dependency exemption and the child credit to a noncustodial parent. Thus, the Senate amendment provision generally grandfathers those custodial waivers that are in place and effective on the date of enactment, and generally retains the custodial waiver rule for purposes of the dependency exemption and the child credit for decrees of divorce or separate maintenance or written separation agreements that become effective after the date of enactment. Under the Senate amendment provision, the custodial waiver rules do not affect eligibility with respect to children of divorced or legally separated parents for purposes of the earned income credit, the dependent care credit, and head of household filing status.

Other provisions

The Senate amendment provision retains the applicable present-law requirements that a taxpayer identification number for a child be provided on the taxpayer's return. For purposes of the earned income credit, a qualifying child is required to have a social security number that is valid for employment in the United States (that is, the child must be a U.S. citizen, permanent resident, or have a certain type of temporary visa).

[349] Individuals who satisfy the present-law dependency tests and who are not qualifying children are referred to as "qualifying relatives" under the provision.

Effect of Senate amendment provision on particular tax benefits

Dependency exemption

For purposes of the dependency exemption, the Senate amendment provision defines a dependent as a qualifying child or a qualifying relative. The qualifying child test eliminates the support test (other than in the case of a child who provides more than one half of his or her own support), and replaces it with the residency requirement described above. Further, the present-law gross income test does not apply to a qualifying child. The rules relating to multiple support agreements do not apply with respect to qualifying children because the support test does not apply to them. Special tie-breaking rules (described above) apply if more than one taxpayer claims a qualifying child under the Senate amendment provision. These tie-breaking rules do not apply if a child constitutes a qualifying child with respect to multiple taxpayers, but only one eligible taxpayer actually claims the qualifying child.

The Senate amendment provision permits taxpayers to continue to apply the present-law dependency exemption rules to claim a dependency exemption for a qualifying relative who does not satisfy the qualifying child definition. In such cases, the present-law gross income and support tests, including the special rules for multiple support agreements, the special rules relating to income of handicapped dependents, and the special support test in case of students, continue to apply for purposes of the dependency exemption.

As is the case under present law, a child who provides over half of his or her own support is not considered a dependent of another taxpayer under the Senate amendment provision. Further, an individual shall not be treated as a dependent of a taxpayer if such individual has filed a joint return with the individual's spouse for the taxable year.

Earned income credit

In general, the Senate amendment provision adopts a definition of qualifying child that is similar to the present-law definition under the earned income credit. The present-law requirement that a foster child and certain other children be cared for as the taxpayer's own child is eliminated. The present-law tie-breaker rule applicable to the earned income credit is used for purposes of the uniform definition of qualifying child. The Senate amendment provision retains the present-law requirement that the taxpayer's principal place of abode must be in the United States.

Child credit

The present-law child credit generally uses the same relationships to define an eligible child as the uniform definition. The present-law requirement that a foster child and certain other children be cared for as the taxpayer's own child is eliminated. The age limitation under the Senate amendment provision retains the present-law requirement that the child must be under age 17, regardless of whether the child is disabled.

Dependent care credit

The present-law requirement that a taxpayer maintain a household in order to claim the dependent care credit is eliminated. Thus, if other applicable requirements are satisfied, a taxpayer may claim the dependent care credit with respect to a child who lives with the taxpayer for more than one half the year, even if the taxpayer does not provide more than one half of the cost of maintaining the household.

The rules for determining eligibility for the credit with respect to an individual who is physically or mentally incapable of caring for himself or herself are amended to include a requirement that the taxpayer and the dependent have the same principal place of abode for more than one half the taxable year.

Head of household filing status

Under the Senate amendment provision, a taxpayer qualifies for head of household filing status with respect to a child who is a qualifying child as defined under the Senate amendment provision. An individual who is not a qualifying child will qualify the taxpayer for head of household status only if, as is the case under present law, the individual is a dependent of the taxpayer and the taxpayer is entitled to a dependency exemption for such individual, or the individual is the taxpayer's father or mother and certain other requirements are satisfied. Thus, under the Senate amendment provision a taxpayer is eligible for head of household filing status only with respect to a qualifying child or an individual for whom the taxpayer is entitled to a dependency exemption.

The Senate amendment provision retains the present-law requirement that the taxpayer provide over one half the cost of maintaining the household.

Effective date

The Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Other Simplification Provisions

1. Consolidation of life insurance and nonlife companies (sec. 511 of the Senate amendment and sec. 1504 of the Code)

Present Law

Under present law, an affiliated group of corporations means one or more chains of includible corporations connected through stock ownership with a common parent corporation (sec. 1504(a)(1)). The stock ownership requirement consists of an 80-percent voting and value test. In general, an affiliated group of corporations may file a consolidated tax return for Federal income tax purposes.

Life insurance companies (subject to tax under section 801) generally are not treated as includible corporations, and therefore may not be included in a consolidated return of an affiliated group including nonlife-insurance companies, unless the common parent of the group elects to treat the life insurance companies as includible corporations (sec. 1504(c)(2)).

Under the election to treat life insurance companies as includible corporations of an affiliated group, two special 5-year limitation rules apply. The first 5-year rule provides that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). The second 5-year rule provides that any net operating loss of a nonlife-insurance member of the group may not offset the taxable income of a life insurance member for any of the first 5 years the life and nonlife-insurance corporations have been members of the same affiliated group (sec. 1503(c)(2)). This rule applies to nonlife losses for the current taxable year or as a carryover or carryback.

A separate 35-percent limitation also applies under the election to treat life insurance companies as includible corporations of an affiliated group (sec. 1503(c)(1)). This rule provides that if the non-life-insurance members of the group have a net operating loss, then the amount of the loss that is not absorbed by carrybacks against the nonlife-insurance members' income may offset the life insurance members' income only to the extent of the lesser of: (1) 35 percent of the amount of the loss; or (2) 35 percent of the life insurance members' taxable income. The unused portion of the loss is available as a carryover and is added to subsequent-year losses, subject to the same 35-percent limitation.

House Bill

No provision.

Senate Amendment

The Senate amendment provision repeals the 5-year limitation providing that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). The provision also repeals the rule that a life insurance corporation is not an includible corporation unless the common parent makes an election to treat life insurance companies as includible corporations (sec. 1504(c)(1)). Thus, under the provision, a life insurance company is treated as an includible corporation starting with the first taxable year for which it becomes a member of the affiliated group and otherwise meets the definition of an includible corporation. The provision retains the 5-year rule of section 1503(c)(2), as well as the 35-percent limitation of present-law section 1503(c)(1) with respect to any life insurance company that is an includible corporation of an affiliated group.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2009. No affiliated group terminates solely by reason of the provision. Under regulations, the provision waives the 5-year waiting period for reconsolidation under section 1504(a)(3), in the case of any corporation that was previously an includible corporation, but was subsequently deemed not to be an includible corporation as a result of becoming a subsidiary of a corporation that was not an includible corporation solely by reason of the 5-year rule of section 1504(c)(2) (providing that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Suspension of reduction of deductions for mutual life insurance companies and of policyholder surplus accounts of life insurance companies (sec. 512 of the Senate amendment and secs. 809 and 815 of the Code)

Present Law

Reduction in deductions for policyholder dividends and reserves of mutual life insurance companies (sec. 809)

In general, a corporation may not deduct amounts distributed to shareholders with respect to the corporation's stock. The Deficit Reduction Act of 1984 added a provision to the rules governing insurance companies that was intended to remedy the failure of prior law to distinguish between amounts returned by mutual life insurance companies to policyholders as customers, and amounts distributed to them as owners of the mutual company.

Under the provision, section 809, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins. Under present law, the differential earnings rate cannot be a negative number.

A company's equity base equals the sum of: (1) its surplus and capital increased by 50 percent of the amount of any provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

A recomputation or "true-up" in the succeeding year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

For a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003, the differential earnings rate is treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount (true-up).

Distributions to shareholders from policyholders surplus account (sec. 815)

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984 included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account (sec. 815).

Under present law, any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

House Bill

No provision.

Senate Amendment

Reduction in deductions for policyholder dividends and reserves of mutual life insurance companies (sec. 809)

The Senate amendment provision provides that for a mutual life insurance company's taxable years beginning after December 31, 2003, and before January 1, 2009, the differential earnings rate is treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount (true-up), under the rules requiring reduction in certain deductions of mutual life insurance companies (sec. 809).

Distributions to shareholders from policyholders surplus account (sec. 815)

The Senate amendment provision suspends for a life insurance company's taxable year beginning after December 31, 2003, and before January 1, 2009, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company (sec. 815). The Senate amendment provision also modifies the order in which distributions reduce the various accounts, so that distributions are treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

Effective date.–The Senate amendment provisions relating to section 809 and section 815 are effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provisions.

3. Section 355 "active business test" applied to chains of affiliated corporations (sec. 513 of the Senate amendment and sec. 355 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[350] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[351]

In determining whether a corporation satisfies the active trade or business requirement, the IRS position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[352] However, if the corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[353]

House Bill

No provision.

Senate Amendme nt

Under the Senate amendment, the active business test is determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). The relevant affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

Effective date.–The Senate amendment applies to distributions after the date of enactment, with three exceptions. The Senate amendment does not apply to distributions (1) made pursuant to an agreement which is binding on the date of enactment and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before the date of enactment, or (3) described on or before the date of enactment in a public announcement or in a

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[350] Section 355(b). If the distributing corporation had no assets other than stock or securities in the controlled corporations immediately before the distribution, then each of the controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business.

[351] Section 355(b)(2)(A).

[352] Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[353] Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

filing with the Securities and Exchange Commission. The distributing corporation may irrevocably elect not to have the exceptions described above apply.

The Senate amendment also applies to any distribution prior to the date of enactment, but solely for the purpose of determining whether, after the date of enactment, the taxpayer continues to satisfy the requirements of section 355(b)(2)(A).[354]

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[354] For example, a holding company taxpayer that had distributed a controlled corporation in a spin-off prior to the date of enactment, in which spin-off the taxpayer satisfied the "substantially all" active business stock test of present law section 355(b)(2)(A) immediately after the distribution, would not be deemed to have failed to satisfy any requirement that it continue that same qualified structure for any period of time after the distribution, solely because of a restructuring that occurs after the date of enactment and that would satisfy the requirements of new section 355(b)(2)(A).

C. Other Provisions

1. Civil rights tax relief (sec. 521 of the Senate amendment and sec. 62 of the Code)

Present Law

Under present law, gross income generally does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) by individuals on account of personal physical injuries (including death) or physical sickness.[355] Expenses relating to recovering such damages are generally not deductible.[356]

Other damages are generally included in gross income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as expenses for the production of income,[357] subject to the two-percent floor on itemized deductions.[358] Thus, such expenses are deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income. Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount.[359] For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction.

In some cases, claimants will engage an attorney to represent them on a contingent fee basis. That is, if the claimant recovers damages, a prearranged percentage of the damages will be paid to the attorney; if no damages are recovered, the attorney is not paid a fee. The proper tax treatment of contingent fee arrangements with attorneys has been litigated in recent years. Some courts[360] have held that the entire amount of damages is income and that the claimant is entitled to a miscellaneous itemized deduction subject to both the two-percent floor as an expense for the production of income for the portion paid to the attorney and to the overall limitation on itemized deductions. Other courts have held that the portion of the recovery that is

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[355] Sec. 104(a)(2).

[356] Sec. 265(a)(1).

[357] Sec. 212.

[358] Sec. 67.

[359] Sec. 68.

[360] *Kenseth v. Commissioner*, 114 T.C. 399 (2000), *aff'd* 259 F.3d 881 (7th Cir. 2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery.[361]

House Bill

No provision.

Senate Amendment

The Senate amendment provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination or certain claims against the Federal Government. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

Under the Senate amendment, "unlawful discrimination" means an act that is unlawful under certain provisions of any of the following: the Civil Rights Act of 1991, the Congressional Accountability Act of 1995, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Age Discrimination in Employment Act of 1967, the Rehabilitation Act of 1973, the Employee Retirement Security Income Act of 1974, the Education Amendments of 1972, the Employee Polygraph Protection Act of 1988, the Worker Adjustment and Retraining Notification Act, the Family and Medical Leave Act of 1993, chapter 43 of Title 38 of the United States Code, the Revised Statutes, the Civil Rights Act of 1964, the Fair Housing Act, the Americans with Disabilities Act of 1990, any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law, or any provision of State or local law, or common law claims permitted under Federal, State, or local law providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Effective date.–The Senate amendment is effective for fees and costs paid after the date of enactment with respect to any judgment or settlement occurring after such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[361] *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Arthur Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). In some of these cases, such as *Cotnam*, State law has been an important consideration in determining that the claimant has no claim of right to the recovery.

2. Increase section 382 limitation for certain corporations in bankruptcy (sec. 522 of the Senate amendment and sec. 382 of the Code)

Present Law

If a corporation with net operating losses experiences an ownership change, then the annual amount of pre-change net operating loss carryovers that it may use against post-change income is limited. The basic annual post-change limit is the value of the corporation's stock at the time of the ownership change, multiplied by the long-term tax-exempt rate (prescribed by the Treasury department) applicable to the time of the change.

In general, an ownership change occurs if, within a three-year period, there is a 50-percentage point increase in ownership by any one or more 5-percent shareholders. A special rule applies to bankruptcy situations. If a corporation is under the jurisdiction of a court in a title 11 or similar case, no ownership change will occur if the shareholders and creditors of the old loss corporation, as a result of owning stock or debt of the old corporation, own at least 50 percent of the stock of the new loss corporation. Only indebtedness held for at least 18 months prior to the date of filing the title 11 or similar case counts for this purpose. In effect, such "old and cold" creditors are treated as persons who had effectively become shareholders of the corporation prior to the ownership change, due to the impending bankruptcy of the corporation.

If "old and cold" creditors dispose of their debt to new persons and those persons become shareholders as a result of owning that debt, the receipt of stock by those persons will be treated as the acquisition of stock by new shareholders, and can trigger an ownership change that causes the section 382 limitation to apply.

House Bill

No provision.

Senate Amendment

For a limited time period, the Senate amendment doubles the amount of the section 382 limitation applicable to corporations that experience an ownership change emerging from bankruptcy in a title 11 or similar case. The Senate amendment applies for a period of two taxable years to corporations that experience an ownership change in a title 11 or similar case after December 31, 2002.

Effective date.–The Senate amendment provision is effective for taxable years beginning in 2004 and 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Increase in historic rehabilitation credit for residential housing for the elderly (sec. 523 of the Senate amendment and sec. 47 of the Code)

Present Law

Rehabilitation credit

Present law provides a credit for rehabilitation expenditures (sec. 47). A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of the adjusted basis of the building (and its structural components), or $5,000. The taxpayer's depreciable basis in the property is reduced by any rehabilitation credit claimed.

Low-income housing credit

The low-income housing tax credit (sec. 42) may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified expenditures. The aggregate credit authority provided annually to each State is $1.75 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts. The $1.75 per resident cap is indexed for inflation.

Qualified basis with respect to which the credit may be computed is generally determined as the portion of the eligible basis of the qualified low-income building attributable to the low-income rental units. Qualified basis generally is the taxpayer's depreciable basis in a qualified low-income building. In the case of a taxpayer who claims the rehabilitation credit for a qualified low-income building, the taxpayer's depreciable basis in the building is reduced by the amount of the rehabilitation credit claimed. In addition, eligible basis is reduced by any Federal grant received with respect to the building. A qualified low-income building is a building that meets certain compliance criteria and is depreciable under the modified accelerated cost recovery system ("MACRS").

House Bill

No provision.

Senate Amendment

The Senate amendment increases the present-law 20-percent credit for historic rehabilitation expenses to 25 percent in the case of rehabilitation expenses incurred with respect to a building which is also a low-income housing credit property in which substantially all of the tenants, both those tenants in rent-restricted units and in other residential units, are age 65 or greater. The Senate amendment permits the 25-percent rehabilitation credit to be claimed with respect to all parts of the building, not only those parts on which the taxpayer also claims the low-income housing credit.[362]

Effective date.–The Senate amendment provision is effective for property placed in service after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Modification of application of income forecast method of depreciation (sec. 524 of the Senate amendment and sec. 167 of the Code)

Present Law

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of

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[362] The Senate amendment also repeals a transition rule to the Tax Reform Act of 1986 permitting the taxpayers who own the property described in sec. 251(d)(4)(X) of the Tax Reform Act of 1986 to use ACRS depreciation, in lieu of MACRS depreciation. This change enables such property to qualify for the provision.

which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

The adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.

The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service, but only if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service (as defined in section 167(g)(1)(A)). For purposes of the provision, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property. The Senate amendment also clarifies that the income from the property to be taken into account under the income forecast method is the gross income from such property.

The Senate amendment also grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the provision.

In addition, the Senate amendment clarifies that, in the case of property eligible for the income forecast method that the holding in the Associated Patentees decision will continue to constitute a valid method of depreciation and may be used in connection with the income forecast method of accounting. Thus, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may elect to deduct those payments as they are paid as under the Associated Patentees decision. This election shall be made on a property-by-property basis and shall be applied consistently with respect to a given property thereafter. The Senate amendment also clarifies that distribution costs are not taken into account for purposes of determining the taxpayer's current and total forecasted income with respect to a property.

Effective date.–The Senate amendment provision applies to property placed in service after date of enactment. No inference is intended as to the appropriate treatment under present law. It is intended that the Treasury Department and the IRS expedite the resolution of open cases. In resolving these cases in an expedited and balanced manner, the Treasury Department and IRS are encouraged to take into account the principles of the bill.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Additional advance refunding of certain governmental bonds (sec. 525 of the Senate amendment and sec. 149 of the Code)

Present Law

Interest on bonds issued by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (section 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called private activity bonds. Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. One such exception is the provision of financing for activities of charitable organizations described in section 501(c)(3) of the Code ("qualified 501(c)(3) bonds").

An advance refunding bond is issued to refund another bond more than 90 days before the redemption of the refunded bond. Under present law, governmental bonds and qualified 501(c)(3) bonds may be advanced refunded, subject to certain limitations described below. Private activity bonds (other than qualified 501(c)(3) bonds) may not be advanced refunded. Bonds eligible for advance refunding can be advance refunded once if the original bond was issued after 1985 or advance refunded twice if the original bond was issued before 1985. Special rules apply for advance refunding bonds under the New York Liberty Zone provisions of the Code (sec. 1400L(e)(3)). "Liberty Advance Refunding Bonds," which may be advance refunded one additional time, are tax-exempt bonds for which all present-law advance refunding authority was exhausted before September 12, 2001, and with respect to which the advance refunding bonds authorized under present law were outstanding on September 11, 2001. In addition, at least 90 percent of the net proceeds of the original bond must have been used to finance facilities located in New York City and must be governmental general obligation bonds issued by either New York City or certain New York State Authorities.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, certain governmental bonds are eligible for an additional advance refunding. To be eligible for an additional refunding, the original bond has to have been part of an issue 90 percent or more of the net proceeds of which were used to finance a public elementary or secondary school in any State in which the State's highest court ruled by opinion issued on November 21, 2002, that the State school funding system violates the State constitution and is constitutionally inadequate. The additional advance refunding bond must be issued before the date, which is two years after the date of enactment of the bill.

Effective date.–The Senate amendment provision is effective for advance refunding bonds issued after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Exclusion of income derived from certain wagers on horse races from gross income of nonresident alien individuals (sec. 526 of the Senate amendment and sec. 872(b) of the Code)

Present Law

Under section 871, certain items of gross income received by a nonresident alien from sources within the United States are subject to a flat 30-percent withholding tax. Gambling winnings received by a nonresident alien from wagers placed in the United States are U.S.-source and thus generally are subject to this withholding tax, unless exempted by treaty. Currently, several U.S. income tax treaties exempt U.S.-source gambling winnings of residents of the other treaty country from U.S. withholding tax. In addition, no withholding tax is imposed under section 871 on the non-business gambling income of a nonresident alien from wagers on the following games (except to the extent that the Secretary determines that collection of the tax would be administratively feasible): blackjack, baccarat, craps, roulette, and big-6 wheel. Various other (non-gambling-related) items of income of a nonresident alien are excluded from gross income under section 872(b) and are thereby exempt from the 30-percent withholding tax, without any authority for the Secretary to impose the tax by regulation. In cases in which a withholding tax on gambling winnings applies, section 1441(a) of the Code requires the party making the winning payout to withhold the appropriate amount and makes that party responsible for amounts not withheld.

With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel[363] event taking place within the United States, the

[363] In pari-mutuel wagering (common in horse racing), odds and payouts are determined by the aggregate bets placed. The money wagered is placed into a pool, the party maintaining

source of the winnings, and thus the applicability of the 30-percent U.S. withholding tax, depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (*e.g.*, a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the United States), then the winnings paid to a nonresident alien generally would not be subject to withholding tax, because the amounts received generally would not be from sources within the United States. However, if the payout is made from a "merged" or "commingled" pool, in which betting pools in the United States and the foreign country are combined for a particular event, then the portion of the payout attributable to wagers placed in the United States could be subject to withholding tax. The party making the payment, in this case a racetrack or off-track betting parlor in a foreign country, would be responsible for withholding the tax.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an exclusion from gross income under section 872(b) for winnings paid to a nonresident alien resulting from a legal wager initiated outside the United States in a pari-mutuel pool on a live horse race in the United States, regardless of whether the pool is a separate foreign pool or a merged U.S.-foreign pool.

Effective date.–The Senate amendment provision applies to proceeds from wagering transactions after September 30, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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the pool takes a percentage of the total, and the bettors effectively bet against each other. Pari-mutuel wagering may be contrasted with fixed-odds wagering (common in sports wagering), in which odds (or perhaps a point spread) are agreed to by the bettor and the party taking the bet and are not affected by the bets placed by other bettors.

7. Federal reimbursement of emergency health services furnished to undocumented aliens (sec. 527 of the Senate amendment)

Present Law

Section 4723 of the Balanced Budget Act of 1997, provided $25 million a year for fiscal years 1998-2001, with the funds allotted to the 12 States with the highest number of undocumented aliens (based on estimates by the Immigration and Naturalization Service for 1992 or later). From that allotment, the Secretary reimbursed each State, or political subdivision thereof, for certain emergency health services furnished to undocumented aliens.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an entitlement of $48 million for fiscal year 2004 for the Federal reimbursement for providers of emergency health services to undocumented aliens.

Effective date.–The Senate amendment provision is effective beginning in fiscal year 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Treatment of premiums for mortgage insurance (sec. 528 of the Senate amendment and sec. 163 of the Code)

Present Law

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is $100,000. The maximum amount of acquisition indebtedness is $1 million. Acquisition indebtedness means debt that is incurred in acquiring constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

House Bill

No provision.

Senate Amendment

The Senate amendment provision provides that premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as qualified residence interest and thus deductible. The amount allowable as a deduction under the provision is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which it is allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Veterans Administration or Rural Housing Administration).

Reporting rules apply under the provision.

Effective date.–The Senate amendment provision is effective for amounts paid or accrued after the date of enactment in taxable years ending after that date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Sense of the Senate on repealing the 1993 tax hike on Social Security Benefits (sec. 529 of the Senate Amendment)

Present Law

Present law provides for a two-tier system of taxation of Social Security benefits. Under this system, up to either 50 percent or 85 percent of Social Security benefits and includible in gross income, depending on the taxpayer's income. The 85-percent tax was enacted in 1993.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a sense of the Senate that the Senate Finance Committee should report out the Social Security Benefits Tax Relief Act of 2003[364] to repeal the tax on seniors not later than July 31, 2003, and that the Senate will consider such bill not later than September 30, 2003, in a manner consistent with the preservation of the Medicare Trust Fund.

Effective date.--The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

10. Sense of the Senate relating to the flat tax (sec. 530 of the Senate amendment)

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a sense of the Senate that the Senate Finance Committee and the Joint Economic Committee should undertake a comprehensive analysis of simplification or flat tax proposals, including appropriate hearings, and consider legislation providing for a flat tax.

Effective date.-- The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

11. Temporary rate reduction for certain dividends received from controlled foreign corporations (sec. 531 of the Senate amendment and new sec. 965 of the Code)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred.

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[364] S. 514.

However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[365] and the passive foreign investment company rules.[366] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[367]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, certain actual and deemed dividends received by a U.S. corporation from a controlled foreign corporation are subject to tax at a reduced rate of 5.25 percent. For corporations taxed at the top corporate income tax rate of 35 percent, this rate reduction is equivalent to an 85-percent dividends-received deduction. This rate reduction is available only for the first taxable year of an electing taxpayer ending 120 days or more after the date of enactment of the provision.

The reduced rate applies only to repatriations in excess of the taxpayer's average repatriation level over 3 of the 5 most recent taxable years ending on or before December 31, 2002, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such 5 years.[368] The taxpayer may designate which of its dividends are treated as meeting the base-period average level and which of its dividends are treated as comprising the excess.

In order to qualify for the reduced rate, dividends must be described in a "domestic reinvestment plan" approved by the taxpayer's senior management and board of directors. This plan must provide for the reinvestment of the repatriated dividends in the United States, "including as a source for the funding of worker hiring and training; infrastructure; research and development; capital investments; or the financial stabilization of the corporation for the purposes of job retention or creation."

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[365] Secs. 951-964.

[366] Secs. 1291-1298.

[367] Secs. 901, 902, 960, 1291(g).

[368] If the taxpayer has fewer than 5 taxable years ending on or before December 31, 2002, then the base period consists of all such taxable years, with none disregarded.

The Senate amendment provision disallows 85 percent of the foreign tax credits attributable to dividends subject to the reduced rate and removes 85 percent of the underlying income from the taxpayer's foreign tax credit limitation fraction under section 904.

In the case of an affiliated group, an election under the provision is made by the common parent on a group-wide basis, and all members of the group are treated as a single taxpayer. The election applies to all controlled foreign corporations with respect to which an electing taxpayer is a United States shareholder.

Effective date.–The Senate amendment provision is effective for the first taxable year of an electing taxpayer ending 120 days or more after the provision's date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

12. Repeal of 10-percent rehabilitation tax credit (sec. 531 of the Senate amendment and section 47 of the Code)

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures (sec. 47).

A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. The pre-1936 building must meet certain requirements in order for expenditures with respect to it to qualify for the rehabilitation tax credit. In the rehabilitation process, certain walls and structures must have been retained. Specifically, (1) 50 percent or more of the existing external walls must be retained in place as external walls, (2) 75 percent or more of the existing external walls of the building must be retained in place as internal or external walls, and (3) 75 percent or more of the existing internal structural framework of the building must be retained in place. Further, the building must have been substantially rehabilitated, and it must have been placed in service before the beginning of the rehabilitation. A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or $5,000.

House Bill

No provision.

Senate Amendment

The Senate amendment provision repeals the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936. The provision retains the present-law 20-percent credit for rehabilitation expenditures with respect to a certified historic structure.

Effective date.--The provision is effective for expenditures incurred after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

13. Income inclusion for certain delinquent child support (sec. 532 of the Senate amendment and sec. 166 of the Code)

Present Law

Bad debt deduction

Non-business bad debts may be deductible as short-term capital losses on Schedule D of the Form 1040. Non-business bad debts generally are debts that the taxpayer did not acquire or create in the course of operating the taxpayer's business. The present-law rule that capital losses (both short-term and long-term) may not exceed the sum of $3,000 plus any capital gains for any taxable year is applicable.

Non-business bad debts are only deductible only if: (1) the debt is wholly worthless (partially worthless debts are not deductible) and (2) the taxpayer has a tax basis in the debt that becomes bad. If these requirements are satisfied, the amount of the deductible non-business bad debt is the individual's basis in the bad debt. Generally, the amount of basis that a taxpayer has in a debt is the amount of the cash advance in the case of a loan or the amount of taxable income recognized by the taxpayer with reference to the debt. Deductions for bad debts are allowed only for the taxable year in which the debt becomes wholly worthless.

Custodial parents do not qualify for a non-business bad debt deduction on unpaid child support because, they have no basis in the debt and the debt may not be wholly worthless.

Bad debt income inclusion

There is no income inclusion for individuals who are delinquent in paying their child support obligations.

House Bill

No provision

Senate Amendment

The Senate amendment creates an income inclusion for a non-custodial parent for certain unpaid child support obligations at the close of a taxable year. The income inclusion is limited to the amount of unpaid child support at the end of the taxable year that equals or exceeds one-half of the non-custodial taxpayer's total child support obligation to the custodial parent for the year. This test is not applied on a child-by-child basis. For example, in the case of child support for two children, the test applies the one-half or more test to the combined child support obligations for both children.

Under the bill, any payments from the non-custodial parent to the custodial parent subsequent to the close of the taxable year are not deductible by the non-custodial parent (regardless of whether the non-custodial parent had a previous income inclusion with regard to such amounts).

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

14. Sense of the Senate regarding the low-income housing tax credit (sec. 533 of the Senate amendment)

Present Law

The low-income housing tax credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures.

The aggregate credit authority provided annually to each State was $1.75 per resident in calendar year 2002. Beginning in calendar year 2003, the per-capita portion of the credit cap will be adjusted annually for inflation. For small States, a minimum annual cap of $2 million was provided for calendar year 2002. Beginning in calendar year 2003, the small State minimum is adjusted for inflation.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a statement that it is the sense of the Senate that any reduction or elimination of the taxation on dividends should include provisions to preserve the success of the low-income housing tax credit.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

15. Expensing of investment in broadband equipment (sec. 534 of the Senate amendment and new sec. 191 of the Code)

Present Law

Under present law, a taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System (MACRS) of section 168, which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.

Personal property is classified under MACRS based on the property's "class life" unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Rev. Proc. 87-56, 1987-2 CB 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 CB 785).

House Bill

No provision.

Senate Amendment

The Senate amendment provides that expenses incurred by the taxpayer for qualified broadband expenditures with respect to qualified equipment placed in service prior to January 1, 2005 may be deducted in full in the year in which the equipment is placed in service.

Qualified expenditures are expenditures incurred with respect to equipment with which the taxpayer offers current generation broadband services to qualified subscribers. In addition, qualified expenditures include qualified expenditures incurred by the taxpayer with respect to qualified equipment with which the taxpayer offers next generation broadband services to qualified subscribers. Current generation broadband services are defined as the transmission of signals at a rate of at least 1 million bits per second to the subscriber and at a rate of at least 128,000 bits per second from the subscriber. Next generation broadband services are defined as the transmission of signals at a rate of at least 22 million bits per second to the subscriber and at a rate of at least 5 million bits per second from the subscriber.

Qualified subscribers for the purposes of the current generation broadband deduction include nonresidential subscribers in rural or underserved areas, and residential subscribers in rural or underserved areas that are not in a saturated market. A saturated market is defined as a census tract in which current generation broadband services have been provided by a single provider to 85 percent or more of the total number of potential residential subscribers residing within such census tracts. For the purposes of the next generation broadband deduction, qualified subscribers include nonresidential subscribers in rural or underserved areas or any residential subscriber. In the case of a taxpayer who incurs expenditures for equipment capable of serving both subscribers in qualifying areas and other areas, qualifying expenditures are determined by multiplying otherwise qualifying expenditures by the ratio of the number of potential qualifying subscribers to all potential subscribers the qualifying equipment would be capable of serving.

Qualifying equipment must be capable of providing broadband services a majority of the time during periods of maximum demand. Qualifying equipment is that equipment that extends from the last point of switching to the outside of the building in which the subscriber is located, equipment that extends from the customer side of a mobile telephone switching office to a transmission/reception antenna (including the antenna) of the subscriber, equipment that extends from the customer side of the headend to the outside of the building in which the subscriber is located, or equipment that extends from a transmission/reception antenna to a transmission/reception antenna on the outside of the building used by the subscriber. Any packet switching equipment deployed in connection with other qualifying equipment is qualifying equipment, regardless of location, provided that it is the last such equipment in a series as part of transmission of a signal to a subscriber or the first in a series in the transmission of a signal from a subscriber. Also, multiplexing and demultiplexing equipment also is qualified equipment.

A rural area is any census tract which is not within 10 miles of any incorporated or census designated place with a population of more than 25,000 and which is not within a county with a population density of more than 500 people per square mile. An underserved area is any census tract which is located in an empowerment zone or enterprise community or any census tract in which the poverty level is greater than or equal to 30 percent and in which the median family income is less than 70 percent of the greater of metropolitan area median family income or Statewide median family income. A residential subscriber is any individual who purchases broadband service to be delivered to his or her dwelling.

<u>Effective date</u>.–The Senate amendment provision is effective for property placed in service after December 31, 2003.

<u>Conference Agreement</u>

The conference agreement does not include the Senate amendment provision.

16. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control State bailment warehouses (sec. 535 of the Senate amendment and new sec. 5011 of the Code)

Present Law

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. Tax on domestically produced and/or bottled distilled spirits arises upon production (receipt) in a bonded distillery and is collected based on removals from the distillery during each semi-monthly period. Distilled spirits that are bottled before importation into the United States are taxed on removal from the first U.S. warehouse where they are landed (including a warehouse located in a foreign trade zone).

No tax credits are allowed under present law for business costs associated with having tax-paid products in inventory. Rather, excise tax that is included in the purchase price of a product is treated the same as the other components of the product cost, i.e., deductible as a cost of goods sold.

House Bill

No provision.

Senate Amendment

The Senate amendment creates a new income tax credit for wholesale distributors, distillers, and importers, of distilled spirits. The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period on an assumed tax rate of $25.68 per case of 12 750-milliliter bottles.

The wholesaler credit only applies to domestically bottled distilled spirits[369] purchased directly from the bottler of such spirits. For distillers and importers, the credit is limited to bottled inventory in a warehouse owned and operated by, or on behalf of, a State when title to such inventory has not passed unconditionally. The credit for distillers and importers applies to distilled spirits bottled both domestically and abroad.

The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold.

The credit cannot be carried back to a taxable year beginning before January 1, 2003.

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[369] Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

17. Contribution in aid of construction (sec. 536 of the Senate amendment and sec. 118 of the Code)

Present Law

Section 118(a) provides that gross income of a corporation does not include a contribution to its capital. In general, section 118(b) provides that a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution as a customer or potential customer and, as such, is includible in gross income of the corporation. However, for any amount of money or property received by a regulated public utility that provides water or sewerage disposal services, such amount shall be considered a contribution to capital (excludible from gross income) so long as such amount: (1) is a contribution in aid of construction, and (2) is not included in the taxpayer's rate base for rate-making purposes. If the contribution is in property other than water or sewerage disposal facilities, the amount is generally excludible from gross income only if the amount is expended to acquire or construct water or sewerage disposal facilities within a specified time period. A contribution in aid of construction does not include a customer connection fee or amounts paid as service charges for starting or stopping services.

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that water and sewer service laterals received by a regulated public utility that provides water or sewerage disposal services is considered a contribution to capital and excludible from gross income of such utility.

Effective date.–The Senate amendment provision is effective for contributions made after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

18. Travel expenses for spouses (sec. 537 of the Senate amendment and sec. 274 of the Code)

Present Law

In general, no deduction is permitted for the travel expenses of a spouse, dependent, or other individual accompanying a taxpayer (or an officer or employee of the taxpayer) on business travel.[370]

House Bill

No provision.

Senate Amendment

The Senate amendment repeals this provision generally prohibiting a deduction for the travel expenses of a spouse, dependent, or other person accompanying a taxpayer (or an officer or employee of a taxpayer). All other present-law limitations on these expenses continue to apply.

Effective date.–The Senate amendment provision is effective for expenses paid or incurred after the date of enactment and on or before December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

19. Certain sightseeing flights exempt from taxes on air transportation (sec. 538 of the Senate amendment and sec. 4281 of the Code)

Present Law

The Code imposes a tax on amounts paid for the taxable transportation of persons ("the ticket tax") (sec. 4261(a)). Taxable transportation for purposes of imposing the ticket tax is transportation that begins and ends in the United States (sec. 4262(a)). Aircrafts having a maximum certificated takeoff weight of 6,000 pounds or less ("small aircraft") are not subject to the ticket tax unless such aircraft is operated on an established line (sec. 4281).

Treasury regulations define the term "operated on an established line" to mean operated with some degree of regularity between definite points (Treas. Reg. sec. 49.4263-5(c)). The term implies that the air carrier maintains control over the direction, routes, time, number of passengers carried, etc. The Treasury regulations also provide that transportation need not be between two definite points to be taxable. A payment for continuous transportation beginning and ending at the same point is subject to the tax (Treas. Reg. sec. 49.4261-1(c)). Thus, the

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[370] Sec. 274(m)(3).

ticket tax applies to regularly conducted sightseeing air tours that begin and end at the same point.[371]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, small aircrafts are not considered as operated on an established line if such aircraft is operated on a flight the sole purpose of which is sightseeing.

Effective date.–The Senate amendment provision is effective with respect to transportation beginning on or after the date of enactment, but does not apply to any amount paid before such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

20. Required coverage for reconstructive surgery following mastectomies (sec. 539 of the Senate amendment and new sec. 9813 of the Code)

Present Law

The Women's Health and Cancer Rights Act of 1998 amended ERISA and the Public Health Service Act to provide that health plans offering mastectomy coverage must also provide coverage for reconstructive breast surgery. Under ERISA, a group health plan, and a health insurance issuer providing health insurance coverage in connection with a group health plan, that provides medical and surgical benefits with respect to mastectomies is required to provide coverage for reconstructive surgery following mastectomies.[372] In the case of a participant or beneficiary who is receiving benefits in connection with a mastectomy and who elects breast reconstruction in connection with such mastectomy, coverage is required for (1) all stages of reconstruction of the breast on which the mastectomy has been performed, (2) surgery and

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[371] *See Lake Mead Air Inc. v. United States*, 99-1 USTC par. 70,119 (D. Nev. 1997). The *Lake Mead* court found that that the tours started and ended at the same point without fail therefore, the flights were between definite points. Finding that the flights were operated with some degree of regularity and between definite points, the court found that the flights were operated on an established line. As a result, the exemption for small aircraft operating on nonestablished lines did not apply and the court concluded that the flights were taxable transportation for purposes of the ticket tax. However, the court found that Lake Mead was not a responsible person for collecting the tax for purposes of the 100 percent penalty imposed by section 6672.

[372] ERISA sec. 713. A similar provision is also included in the Public Health Service Act.

reconstruction of the other breast to produce a symmetrical appearance, and (3) prostheses and physical complications of mastectomy, including lymphedemas, in a manner determined in consultation with the attending physician and the patient.

Coverage may be subject to annual deductibles and coinsurance provisions as may be deemed appropriate and as are consistent with those established for other benefits under the plan or coverage. Written notice of the availability of the coverage must be delivered to the participant upon enrollment and annually thereafter. Notice must be in writing and prominently positioned in any literature or correspondence made available or distributed by the plan or issuer and must be transmitted as specifically required.

A group health plan may not deny a patient eligibility, or continued eligibility, to enroll or to renew coverage under the terms of the plan, solely for the purpose of avoiding the requirements of the provision. In addition, a group health plan may not penalize or otherwise reduce or limit the reimbursement of an attending provider, or provide incentives (monetary or otherwise) to an attending provider, to induce such provider to provide care to an individual participant or beneficiary in a manner inconsistent with the provision. Nothing in the section should be construed to prevent a group health plan from negotiating the level and type of reimbursement with a provider for care provided in accordance with the section.

The Code imposes an excise tax on failures to meet certain group health plan requirements.[373] The excise tax is equal to $100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

Present law does not impose an excise tax relating to required coverage for reconstructive surgery following mastectomies.

House Bill

No provision.

Senate Amendment

The Senate amendment adds to the Code a provision requiring a group health plan that provides medical and surgical benefits with respect to a mastectomy to provide coverage for reconstructive surgery following the mastectomy. The requirements follow those of ERISA. A group health plan that does not comply with the requirements of the provision is subject to the excise tax on failures to meet certain group health plan requirements.[374]

[373] Sec. 4980D.

[374] Sec. 4980D.

Under the new Code section, a group health plan that provides medical and surgical benefits with respect to a mastectomy must provide, in the case of a participant or beneficiary who is receiving benefits in connection with a mastectomy and who elects breast reconstruction in connection with such mastectomy, coverage for (1) all stages of reconstruction of the breast of which the mastectomy has been performed, (2) surgery and reconstruction of the other breast to produce a symmetrical appearance, and (3) prostheses and physical complications of mastectomy, including lymphedemas, in a manner determined in consultation with the attending physician and the patient.

Coverage may be subject to annual deductibles and coinsurance provisions as deemed appropriate and consistent with those established for other benefits under the plan. Written notification of the availability of such coverage must be delivered to the participant upon enrollment and annually thereafter. Unlike ERISA, the specific manner in which notice must be given is not included in the new Code provision.

Under the Senate amendment, a group health plan may not deny a patient eligibility, or continued eligibility, to enroll or to renew coverage under the terms of the plan, solely for the purpose of avoiding the requirements of the provision. In addition, a group health plan may not penalize or otherwise reduce or limit the reimbursement of an attending provider, or provide incentives (monetary or otherwise) to an attending provider, to induce such provider to provide care to an individual participant or beneficiary in a manner inconsistent with the provision. Nothing in the provision should be construed to prevent a group health plan from negotiating the level and type of reimbursement with a provider for care provided in accordance with the provision.

Under the Senate amendment, in the case of a group heath plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by the provision will not be treated as a termination of the collective bargaining agreement.

Effective date.–The Senate amendment provision is effective for plan years beginning on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

21. Renewal community modifications (secs. 540 and 541 of the Senate amendment and secs. 1400E and 1400H of the Code)

Present Law

The Code authorizes the designation of 40 "renewal communities" within which special tax incentives will be available. The following is a description of the designation process and the tax incentives that will be available within the renewal communities.

Designation process

Designation of 40 renewal communities.–The Secretary of HUD, was authorized to designate up to 40 renewal communities from areas nominated by States and local governments. At least 12 of the designated communities must be in rural areas. The designation of an area as a renewal community terminates after December 31, 2009.

Eligibility criteria.–To be designated as a renewal community, a nominated area must meet the following criteria: (1) each census tract must have a poverty rate of at least 20 percent; (2) in the case of an urban area, at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty, unemployment, and general distress. Generally, those areas with the highest average ranking of eligibility factors (1), (2), and (3) above will be designated as renewal communities.

The boundary of a renewal community must be continuous. In addition, the renewal community must have a minimum population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000. The population limitations do not apply to any renewal community that is entirely within an Indian reservation.

In addition, certain State and local government commitments are necessary for an area to receive designation.

Tax incentives for renewal communities

The following tax incentives generally are available during the period beginning January 1, 2002, and ending December 31, 2009.

Zero-percent capital gain rate.–A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years. A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, is not eligible for the zero-percent rate.

Renewal community employment credit.–A 15-percent wage credit is available to employers for the first $10,000 of qualified wages paid to each employee who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business of the employer. In general, any taxable business carrying out activities in the renewal community may claim the wage credit.

Commercial revitalization deduction.–Each State is permitted to allocate up to $12 million of "commercial revitalization expenditures" to each renewal community located within the State for each calendar year after 2001 and before 2010. The appropriate State agency will make the allocations pursuant to a qualified allocation plan. A "commercial revitalization expenditure" means the cost of a new building or the cost of substantially rehabilitating an existing building. The qualifying expenditures for any building cannot exceed $10 million.

Additional section 179 expensing.–A renewal community business is allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service after December 31, 2001, and before January 1, 2010. The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $200,000.

Extension of work opportunity tax credit ("WOTC").–The provision expands the high-risk youth and qualified summer youth categories in the WOTC to include qualified individuals who live in a renewal community.

Expiration date

The tax benefits available in renewal communities are effective for the period beginning January 1, 2002, and ending December 31, 2009.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that an employee who resides in one area that is designated as a renewal community, but who works in a certain other area that also is designated as a renewal community qualifies for the renewal community employment credit. To qualify the area of residence and the area of employment must be in the same State and within five miles.

In addition, the Senate amendment provides that, at the request of the local community, the Secretary of Housing and Urban development may expand the size of an existing renewal community to include a census tract that satisfy eligibility standards based on the 2000 Census, but which did not qualify based on the 1990 Census solely by reason of applicable 1990 population or poverty requirements. The Senate amendment also permits, upon the request of the local community, the Secretary of Housing and Urban Development to expand the size of an existing renewal community to include certain adjacent census tracts populated with 100 or fewer persons.

Effective date.–The Senate amendment provisions are effective as if included in the Community Renewal Tax Relief Act of 2000.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

22. Combat zone expansions (secs. 542 and 543 of the Senate amendment and sec. 112 of the Code)

Present Law

In general, gross income does not include compensation for active service in the armed forces of the United States below the grade of commissioned officer for any month during which the service person served in a combat zone.[375] For commissioned officers, the maximum excludible under this provision is the highest level of pay for an enlisted person. In general, the determination that an area is a combat zone is made by the President by an Executive Order.[376]

House Bill

No provision.

Senate Amendment

The Senate amendment removes the limitation on this exclusion for commissioned officers, so that their entire basic pay is excludible. The Senate amendment also provides that direct transit to and from a combat zone (not to exceed 14 days) is treated as service in a combat zone. The Senate amendment treats military service as part of Operation Iraqi Freedom in Guantanamo Bay, Cuba, and Diego Garcia as if it were in a combat zone.

Effective date.–The Senate amendment provision is effective on January 1, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[375] Sec. 112.

[376] Sec. 112(c)(2).

23. Ratable income inclusion for citrus canker tree payments (sec. 544 of the Senate amendment and sec. 451 and 1033 of the Code)

Present Law

Generally, a taxpayer recognizes gain on the sale or exchange of property to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier) and generally ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized. Longer replacement periods are available in the case of real property and principal residences involuntarily converted as a result of Presidentially declared disaster.

House Bill

No provision.

Senate Amendment

The Senate amendment permits a taxpayer to elect to recognize any realized gain by reason of receiving a citrus canker tree payment ratably over a 10-year period beginning with the taxable year in which such payment is received or accrued by the taxpayer. The provision defines a citrus canker tree payment as a payment made to an owner of a commercial citrus grove to recover income that was lost as a result of the removal of commercial citrus trees to control canker under the amendments to the citrus canker regulations made by the final rule published in the Federal Register by the Secretary of the Agriculture on June 18, 2001. An election under the provision is made by attaching a statement to that effect in the taxpayer's return for the taxable year in which the payment is received or accrued in the manner as the Secretary prescribes. An election is binding for that taxable year and all subsequent taxable years.

The Senate amendment also extends the applicable period under section 1033 for a taxpayer to replace commercial citrus trees which are involuntarily converted under a public order as a result of citrus tree canker to four years. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis if a State or Federal health authority determines that the land on which such trees grew is not free from the bacteria that causes citrus tree canker.

Effective date.–The Senate amendment provision is effective for taxable years beginning before, on, or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

24. Exclusion of certain punitive damage awards (sec. 545 of the Senate amendment and sec. 104 of the Code)

Present Law

Under present law, gross income generally does not include the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) by individuals on account of personal physical injuries (including death) or physical sickness.[377] However, this exclusion does not apply to punitive damages.[378]

House Bill

No provision.

Senate Amendment

The Senate amendment provides an exclusion from gross income for any portion of an award of punitive damages in a civil action that is paid to a State under a split-award statute or any attorneys' fees or other costs incurred by the taxpayer in connection with obtaining such an award which are allocable to such portion.

Under the Senate amendment, a "split-award statute" is a State law that requires a fixed portion of an award of punitive damages in a civil action to be paid to the State.

Effective date.–The Senate amendment applies to awards made in taxable years ending after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[377] Sec. 104(a)(2).

[378] *Id.*

25. Repeal of pre-1997 tax on certain imported recycled halons (sec. 546 of the Senate amendment and sec. 4682 of the Code)

Present Law

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount was $5.80 per pound in 1996 and $6.25 per pound in 1997, and increased by $0.45 cents per pound per year thereafter. The ozone-depleting factors for taxable halons are three for halon-1211, 10 for halon-1301, and six for halon-2402.

In general, taxable chemicals that are recovered and recycled within the United States are exempt from tax. In addition, exemption is provided for imported recycled halon-1301 and halon-2402 if such chemicals are imported after December 31, 1996, from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that no tax is liable for imported recycled halon-1301 or halon-2402 if such chemicals were imported after December 31, 1993, from countries that were signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer at the time such chemicals were imported. In addition, the Senate amendment provides that no tax is liable for imported recycled halon-1211 if such chemicals were imported after December 31, 1993 and before August 5, 1997, from countries that were signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer at the time such chemicals were imported. If, before the end of the one-year period commencing with the date of enactment, any taxpayer who previously paid tax under the then prevailing law files for a refund or credit of taxes paid, such refund or credit is to be made.

Effective date.–The Senate amendment provision is effective upon the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

26. Modification of involuntary conversion rules for businesses affected by the September 11, 2001 terrorist attacks (sec. 547 of the Senate amendment and sec. 1400L of the Code)

Present Law

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[379] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[380]

The Jobs Creation and Worker Assistance Act of 2002[381] extends the replacement period to five years for a taxpayer to purchase property to replace property that was involuntarily converted within the New York Liberty Zone[382] as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

House Bill

No provision.

Senate Amendment

For property that was involuntarily converted within the New York Liberty Zone as a result of the terrorist attacks that occurred on September 11, 2001, the Senate amendment provides that if a taxpayer is a member of an affiliated group of corporations filing a

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[379] Section 1033(a)(2)(B).

[380] Section 1033(g)(4).

[381] Pub. Law No. 107-147, sec. 301 (2002).

[382] The "New York Liberty Zone" generally is the area located on or south of Canal street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York, New York.

consolidated return that replacement property may be purchased by any member of the affiliated group (in lieu of the taxpayer).[383]

Effective date.–The Senate amendment provision is effective for involuntary conversions in the New York Liberty Zone occurring on or after September 11, 2001.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[383] It is anticipated that the Secretary of the Treasury will issue guidance as may be necessary to ensure that gain shall not be recognized under the consolidated return provisions and to ensure that any investment adjustments, or any other adjustments under the consolidated regulations, accurately reflect the implications of permitting another member of the consolidated group to purchase the replacement property.

D. Medicare Provisions (secs. 561-576 of the Senate amendment)

Present Law

Standardized Amount Equalization

Present law pays rural and small urban facilities 1.6 percent less on every inpatient discharge than their counterparts in urban areas of a million or more people.

Equalization of Medicare Disproportionate Share (DSH) Payments

Present law differentiates between rural and urban hospitals that treat vulnerable populations.

Assistance for Low Volume Hospitals

Present law fails to recognize the special costs incurred by hospitals with less than 2,000 discharges per year.

Revision of Labor Share to 62 percent

Medicare's standardized amounts are apportioned into a labor-related amount (which is then adjusted by the wage index value of the area where the hospital is located or to which it has been reassigned) and a nonlabor-related amount (which is generally not subject to geographical adjustment). Under present law, the labor-related amount comprises 71.1 percent of the national standardized amount.

Extend Hold Harmless for Rural Hospitals under Hospital Outpatient Prospective Payment System

Present law payments to outpatient hospital departments vary from year to year.

Critical Access Hospital Improvements

Many rural hospitals have elected to become critical access hospitals (CAHs) under present law.

10-percent Add-on for Rural Home Health Agencies

Special add-on payment to rural home health agencies expired on April 1, 2003.

Five-percent Add-on for Clinic and Emergency Room Visits for Small Rural Hospitals

Present law treats clinic and emergency room visits no differently than other services provided by the hospital.

Five-percent Add-on for Rural Ground Ambulance Trips

Present law fails to compensate for the long distances rural ambulances drive to treat patients.

Exclusion of Services Provided By Rural Health Clinic-based Practitioners from SNF Consolidated Billing

Present law requires providers based in a rural health clinic to submit their bills for services provided to nursing home patients to the nursing home rather than to Medicare.

Make 10-percent Bonus Payments under Medicare Incentive Payment Program Automatic

Present law requires physicians participating in the Medicare Incentive Payment program to apply for bonus payments when they elect to serve in Health Professional Shortage Areas.

Two-Year Extension of Reasonable Cost Payments for Laboratory Tests in Sole Community Hospitals

Present law allows laboratory tests performed in sole community hospitals to be paid at their reasonable cost, rather than under a fee schedule.

Set Work, Practice Expense and Malpractice Geographic Indices for Physician Payments at 1.0

Present law adjusts three components of physician payments under the physician fee schedule based on geography.

10-Year Freeze in CPI Updates for Durable Medical Equipment, Prosthetics and Orthotics

Present law produces payment updates equal to CPI for providers and suppliers in this category.

Collect Coinsurance and Deductible Amounts for Clinical Laboratory Tests

Present law includes no cost-sharing obligation for clinical laboratory tests.

Limit Reimbursement for Currently Covered Drugs

Present law pays for limited prescription drugs and biologicals at 95 percent of the product's average wholesale price.

House Bill

No provision.

Senate Amendment

Standardized Amount Equalization

The Senate amendment raises the inpatient base rate for hospitals in rural and small urban areas to the same rate as that in large urban areas.

Equalization of Medicare Disproportionate Share (DSH) Payments

The Senate amendment equalizes payments to both rural and urban hospitals that receive Medicare DSH payments.

Assistance for Low Volume Hospitals

The Senate amendment improves payments for those hospitals with extremely low annual patient volume.

Revision of Labor Share to 62 percent

The Senate amendment reduces the labor-related amount to 62 percent of the national standardized amount.

Extend Hold Harmless for Rural Hospitals under Hospital Outpatient Prospective Payment System

The Senate amendment protects rural hospitals against possible reductions due to the new outpatient prospective payment system through 2006.

Critical Access Hospital Improvements

The Senate amendment (1) reinstates Periodic Interim Payment (PIP), which provides facilities with a steadier stream of payment in order to improve their cash flow; (2) eliminates the current requirement that CAH-based ambulance services be at least 35 miles from another ambulance service in order to receive cost-based payment; and (3) provides coverage for emergency on-call providers, and (4) excludes CAHs from the wage index calculation.

10-percent Add-on for Rural Home Health Agencies

The Senate amendment extends special add-on payments that expired April 1, 2003 to rural home health agencies and makes them permanent.

Five-percent Add-on for Clinic and Emergency Room Visits for Small Rural Hospitals

The Senate amendment increases Medicare payment for visits to small rural hospitals' outpatient clinics and emergency rooms, which serve a critical primary care function in rural areas.

Five-percent Add-on for Rural Ground Ambulance Trips

The Senate amendment extends a five-percent add-on payment for all ground ambulance trips provided in a rural area.

Exclusion of Services Provided By Rural Health Clinic-based Practitioners from SNF Consolidated Billing

The Senate amendment exempts practitioners based in rural health clinics from the requirement to submit their bills for services provided to nursing home patients to the nursing home rather than to Medicare, reducing administrative burdens and making their payments more predictable.

Make 10-percent Bonus Payments under Medicare Incentive Payment Program Automatic

Present law requires physicians participating in the Medicare Incentive Payment program to apply for bonus payments when they elect to serve in Health Professional Shortage Areas. The Senate amendment makes bonus payments automatic to physicians participating in the Medicare Incentive Payment program, eliminating bureaucratic barriers to receipt of such funds.

Two-Year Extension of Reasonable Cost Payments for Laboratory Tests in Sole Community Hospitals

The Senate amendment extends the allowance for laboratory tests performed in sole community hospitals to be paid at their reasonable cost, rather than under a fee schedule for an additional two years.

Set Work, Practice Expense and Malpractice Geographic Indices for Physician Payments at 1.0

The Senate amendment sets a floor of 1.0 on geographic adjustments to the work, practice expense and professional liability insurance components of physician payment.

10-Year Freeze in CPI Updates for Durable Medical Equipment, Prosthetics and Orthotics

The Senate amendment freezes CPI updates for payment for durable medical equipment, prosthetics, and orthotics for ten years.

Collect Coinsurance and Deductible Amounts for Clinical Laboratory Tests

The Senate amendment extends the same coinsurance and deductible rules to clinical laboratory tests that apply to all other Part B services.

Limit Reimbursement for Currently Covered Drugs

The Senate amendment lowers that amount paid for limited prescription drugs and biologicals to 85 percent of the product's average wholesale price, or the amount payable for the product during the last quarter of the previous year, whichever is lower.

Conference Agreement

The conference agreement does not in the Senate amendment provisions.

E. Provisions Relating to S Corporations
(secs. 581-594 of the Senate amendment and sections 1361-1379 of the Code)

1. Shareholders of an S corporation

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 75-shareholders; (2) as a shareholder, a person (other than certain trusts, estates, charities, and qualified retirement plans) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means any corporation that is a member of an affiliated group, certain financial institutions that use the reserve method of accounting for bad debts, certain insurance companies, a section 936 corporation, or a DISC or former DISC.

House Bill

No provision.

Senate Amendment

The Senate amendment provision provides that all family members owning stock can elect to be treated as one shareholder. A family is defined as the lineal descendants of a common ancestor (and their spouses). The common ancestor cannot be more than six generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of this provision, if later). The election is made available to only one family per corporation, must be made with the consent of all shareholders of the corporation and remains in effect until terminated.

The Senate amendment provision increases the maximum number of eligible shareholders from 75 to 100.

Finally, under the Senate amendment nonresident aliens are allowed as beneficiaries of an electing small business trust.

Effective date.–The Senate amendment provisions apply to taxable years beginning after December 31, 2003, except that the provision relating to nonresident aliens is effective on date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Termination of election and additions to tax due to passive investment income

<u>**Present Law**</u>

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer. "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

<u>**House Bill**</u>

No provision.

<u>**Senate Amendment**</u>

The Senate amendment provision increases the 25-percent threshold to 60 percent.

Also, the Senate amendment repeals capital gain as a category of passive income.

<u>Effective date</u>.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

<u>**Conference Agreement**</u>

The conference agreement does not include the Senate amendment provision.

3. Treatment of S corporation shareholders

(a) In general

<u>**Present Law**</u>

In general, each S corporation shareholder takes into account its pro rata share of the S corporation income and loss for the taxable year.

House Bill

No provision.

Senate Amendment

The Senate amendment provision makes the following changes in the treatment of S corporation shareholders:

Under the Senate amendment provision, if a shareholder's stock in an S corporation is transferred incident to a divorce decree, the pro rata share of any suspended corporate loss is transferred to the transferee spouse.

Under the Senate amendment provision, the beneficiary of a qualified subchapter S trust is allowed the suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the stock.

Effective date.–The Senate amendment provisions apply to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(b) Electing small business trusts

Present Law

Under present law, an electing small business trust ("ESBT") may be an S corporation shareholder. In general, the beneficiaries of an ESBT must be individuals and others taxpayers that may own stock in an S corporation directly. Each potential current beneficiary of the trust is counted as a shareholder in determining whether or not the corporation meets the requirement that an S corporation have no more than 75 shareholders.

The portion of the trust consisting of S corporation stock is treated as a separate trust. The trust is taxed at the maximum trust tax rate (which is the same as the maximum individual tax rate) on the items of income, deduction, gain, or loss passing through from the S corporation. The remaining portion of the trust is treated as a separate trust taxed under the normal rules relating to the taxation of trusts and beneficiaries. In computing the amount ofthe distribution deduction for the trust, no subchapter S items are taken into account.

House Bill

No provision.

Senate Amendment

Under the Senate amendment provision, unexercised powers of appointment are disregarded in determining the beneficiaries of an electing small business trust.

Under the Senate amendment provision, the treatment of distributions from an electing small business trust is clarified by treating distributions from each portion (i.e., the portion attributable to the S corporation stock and the remaining portion) of the trust as separate distributions.

Effective date.–The Senate amendment provisions apply to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the provision in the Senate amendment provision.

4. Provisions relating to banks

(a) IRAs holding bank stock

Present Law

An individual retirement arrangement ("IRA") may not hold stock in an S corporation.

The Code contains rules prohibiting certain transactions between disqualified persons and certain tax-favored retirement arrangements, including IRAs. These rules are designed to prevent certain self-dealing transactions. For example, the sale of an asset held by an IRA to the beneficiary of the IRA is a prohibited transaction. In general, an excise tax is imposed on prohibited transactions. In the case of an IRA, however, if the IRA beneficiary engages in a prohibited transaction, the excise tax does not apply and, instead, the IRA ceases to be an IRA.

House Bill

No provision.

Senate Amendment

The Senate amendment provision provides that the sale of holding bank stock held in an IRA to the beneficiary of the IRA is not a prohibited transaction, in order to allow the corporation to be eligible to elect to be an S corporation.

Effective date.–The Senate amendment provision applies to stock held by an IRA on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(b) Exclusion of investment securities income from passive income test for bank S corporations

Present Law

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer. "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

House Bill

No amendment.

Senate Amendment

The Senate amendment provision provides that, in the case of a bank or bank holding company, passive income does not include interest and does not include dividends on assets required to be held by the bank or bank holding company.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(c) Treatment of qualifying director shares

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 75 shareholders; (2) as a shareholder, a person (other than certain trusts, estates, charities, or qualified retirement plans) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock.

House Bill

No provision.

Senate Amendment

Under the Senate amendment provision, shares held by reason of being a bank director that are subject to an agreement pursuant to which the holder is required to dispose of the shares upon termination of the holder's status as a director at the same price the individual acquired the shares are not treated as a second class of stock. Distributions are treated like interest payments.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Qualified subchapter S subsidiaries

(a) Relief from inadvertently invalid qualified subchapter S subsidiaries and elections and terminations

Present Law

Under present law, inadvertent subchapter S elections and terminations may be waived.

House Bill

No provision.

Senate Amendment

The Senate amendment provision allows inadvertent qualified subchapter S subsidiary elections and terminations to be waived by the IRS.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(b) Information returns for qualified subchapter S subsidiaries

Present Law

Under present law, a wholly owned subsidiary of an S corporation may elect to be treated as not a separate corporation. The assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as assets, liabilities, and items of the parent S corporation.

House Bill

No provision

Senate Amendment

The Senate amendment provision provides authority to the Secretary of the Treasury to provide guidance regarding information returns of subchapter S subsidiaries.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Elimination of all earnings and profits attributable to pre-1983 years

Present Law

The Small Business Job Protection Act of 1996 provided that if a corporation was an S corporation for its first taxable year beginning after 1996, the accumulated earnings and profits of the corporation were reduced as of the beginning of that year by the accumulated earnings and profits (if any) accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S.

House Bill

No provision.

Senate Amendment

The Senate amendment provision eliminates all accumulated earnings and profits of a corporation accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.